

Detecting Problematic D&O Risks

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The average claim against directors and officers costs \$3.2 million in indemnity (\$14.3 million for shareholder claims), and defense costs can be in the millions.² With these large numbers, any kind of frequency is problematic. The challenge for the underwriter is detecting problem accounts before they become insureds in the first place. This article lists eight factors that are indicators of future problems, along with supportive questions an underwriter may ask to find out if the problems exist. These questions will help an underwriter identify problem accounts before they become insureds.

It is important to note that this list does not address accounting irregularities, as they are addressed in more detail in a separate memorandum under identical distribution.

1. **Stock Transactions:**

- Is the stock value steady over time, or is it volatile? Is it more volatile than the industry and economy suggests is reasonable? The more volatility and the more trading, the more risk.
- Do the insiders have a history of trading? If so, are the trades erratic, are they only after sharp stock value increases, or are the trades within a regular trading pattern? Irregular patterns are problematic in litigation.
- Does the company have trading policies governing the trading in its own stock by employees, officers and directors? How are they disseminated, how often, and to whom? Trading policies should be sent at least once a year to all employees and executives.
- Does the company have trading windows for employees? Are there different windows for different levels of employees, which is appropriate?
- Are wages and other perquisites dependent upon profitability, giving rise to a motivation to manipulate stock pricing?

2. **Market Communications:**

- Does the company give significant guidance to analysts? The more said, the more risk.

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² Tillinghast-Towers Perrin, *2000 Directors' and Officers' Liability Survey*; PriceWaterhouseCoopers, *2000 Securities Litigation Study*.

- Does the company stick to hard information, or does it get involved with more risky soft information?
- Does the company use press releases and statements as the backbone for analyst meeting disclosures? This avoids inconsistencies.
- Does the company use a 'safe harbor' disclaimer on discussions, noting risk factors that may cause results to vary from the predictions? Does counsel prepare the safe harbor statement, and how often is it updated? 'Cookie-cutter' disclaimers may not have the same legal efficacy as those drafted for the specific situation.
- Does the company have any history of surprising the analysts? The more surprises, the more risk.
- Is one person (or a limited number of people) authorized to communicate with the public and analysts? Control is essential to prevent material misstatements or omissions.
- Is that person trained in what kind of information to give, how it should be delivered, and when it should be given to the public and analysts?
- Is communication regular? Erratic communication is problematic.
- Does the company avoid reviewing and approving analyst reports? Advance approval of analyst statements can give rise to liability for those statements.
- Does the company rehearse and otherwise prepare for analyst meetings? The more preparation and rehearsals, the fewer surprises and misstatements.

3. **Document Retention:**

Does the company have a document retention policy? Books and records are key in creating, managing and defending a lawsuit.

4. **Audit Committee:**

- Does the company have an independent audit committee?
- Are there at least three members, and do they have financial acumen and experience?
- Do they meet regularly, and do they report directly to the board of directors?

5. **Business Model:**

Is there a sustainable business model? Is there a business plan and is it reasonable to suggest that it can and will work? Profits seem to mitigate lawsuits, and lack of profits seems to engender them.

6. **Technology:**

Is there a methodology for managing technology? Technology is among the most expensive, volatile and valuable assets in a company today and must be under close eye.

7. **Code of Conduct:**

- Is there a company code of conduct?
- How is it disseminated to employees and executives?
- Do they have to sign it periodically indicating receipt and assent?
- Is there a forum for complaints?
- Is there a compliance officer?

8. **Web Sites:**

- What kind of information is posted on the proposed insured's website? Hard information such as product information, or softer information such as earnings projections and the like? Clearly the latter should be handled separately.
- How long does information remain posted on the website? Is there a regular policy and procedure for updating the site? Information can become inaccurate with passage of time, leading to liability.
- Is the information factual or soft? The latter can give rise to litigation.
- When the user leaves the site, is that fact made clear? This reduces the risk of liability for defamation or other problems raised in the site of another party to which the company is linked.